DEPARTMENT OF STATE REVENUE
LETTER OF FINDINGS NUMBER: 07-0050
Financial Institutions Tax
For The Tax Years 2001-2002

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ISSUES

I. Financial Institutions Tax – Imposition.

Authority: IC § 6-8.1-5-1(c); IC § 6-5.5-2-1(a); IC § 6-5.5-1-17(a); IC § 6-5.5-1-17(d); IC § 6-8.1-3-3(b); *Black's Law Dictionary* (8th Edition 2004); *Webster's II New Riverside University Dictionary* (1988); *Caterpillar Financial Services Corp. v Indiana Department of State Revenue,* 849 N.E.2d 1235 (Ind. Tax Ct. 2005).

The Taxpayer protests the imposition of financial institutions tax.

II. Financial Institutions Tax – Indiana Income.

Authority: IC § 6-5.5-3-1; IC § 6-8.1-5-1(c).

The Taxpayer protests the determination that it earned Indiana income.

III. Tax Administration - Ten Percent Negligence Penalty.

Authority: IC § 6-8.1-10-2.1; 45 IAC 15-11-2(b)(c).

The Taxpayer protests the imposition of the ten percent negligence penalty.

STATEMENT OF FACTS

The Taxpayer, a Delaware corporation organized in November 2000, is part of a network of affiliated corporations. The creation of the Taxpayer was part of a corporate restructuring in 2000. The Taxpayer was formed to perform certain financial functions for the group of related corporations that had previously been performed by the financial services business unit of the parent corporation. The parent also transferred working capital and real estate notes to the Taxpayer. The Taxpayer's revenue consists of interest income from promissory notes from the various affiliated group members. The parent corporation also receives substantial dividend payments from the Taxpayer. The Taxpayer is a holding company for Corporation "A," a Bermuda corporation organized in October 2000. For federal income tax purposes, Corporation "A" is a disregarded entity. The parent and affiliated corporations filed combined Indiana adjusted gross income tax returns for the tax years 2001-2002. Because Corporation "A" was a disregarded entity, Corporation "A's" income is reported by the Taxpayer. Since Corporation "A" is a Bermuda corporation, the Taxpayer was not included in the group's combined adjusted gross income tax return. The Department audited the group of affiliated corporations for the tax years 2001-2002. The Department assessed financial institutions tax, interest and penalty against the Taxpayer. The Taxpayer protested the assessments and a hearing was held. This Letter of Findings results.

I. Financial Institutions Tax – Imposition.

DISCUSSION

The Department considered the Taxpayer a financial institution for tax purposes and subject to Indiana financial institutions tax. The Taxpayer protested the assessment contending that it was not a financial institution and the Department erroneously assessed the financial institutions tax. Alternatively, the Taxpayer argued that if the Department finds that the Taxpayer was subject to the financial institutions tax, the Department incorrectly determined the apportionment of income to Indiana.

The first issue to be considered is whether or not the Taxpayer is subject to the Indiana financial institutions tax.

The Department determined that the Taxpayer was a financial institution subject to the financial institutions tax because more than 80 percent of the Taxpayer's income came from commercial loans. The Taxpayer disagreed.

All tax assessments are presumed to be valid. IC § 6-8.1-5-1(c). The Taxpayer bears the burden of proving that any assessment is incorrect. *Id.*

Indiana imposes a financial institutions tax at IC § 6-5.5-2-1(a) as follows:

> There is imposed on each taxpayer a franchise tax measured by the taxpayer's adjusted gross income or apportioned income for the privilege of exercising its franchise or the corporate privilege of transacting the business of a financial institution in Indiana.

Taxpayers subject to the tax are delineated at IC § 6-5.5-1-17(a) as follows:

> A corporation that is transacting the business of a financial institution in Indiana, including any of the following:
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> (1) A holding company.
> (2) A regulated financial corporation.
> (3) A subsidiary of a holding company or a regulated financial corporation.
> (4) Any other corporation organized under the laws of the United States, this state, any other taxing jurisdiction, or a foreign government that is carrying on the business of a financial institution.

To be considered a financial institution subject to the financial institutions tax, the Taxpayer must be carrying on the business of a financial institution and receive at least 80 percent of its gross income from one of the activities listed at IC § 6-5.5-1-17(d) as follows:

> (2) For any other corporation described in subsection (a)(4), all of the corporation's business activities if eighty percent (80 [percent]) or more of the corporation's gross income, excluding extraordinary income, is derived from one (1) or more of the following activities:
>
> (A) Making, acquiring, selling, or servicing loans or extensions of credit. For the purpose of this subdivision, loans and extensions of credit include:
> (i) secured or unsecured consumer loans;
> (ii) installment obligations;
> (iii) mortgage or other secured loans on real estate or tangible personal property;
> (iv) credit card loans;
> (v) secured and unsecured commercial loans of any type;
> (vi) letters of credit and acceptance of drafts;
> (vii) loans arising in factoring; and
> (viii) any other transactions with a comparable economic effect.
>
> (B) Leasing or acting as an agent, broker, or advisor in connection with leasing real and personal property that is the economic equivalent of the extension of credit if the transaction is not treated as a lease for federal income tax purposes.
>
> (C) Operating a credit card, debit card, charge card, or similar business.

The Department determined that the Taxpayer met the two tests to be a taxpayer subject to the financial institutions tax. First, it was a corporation that carried on the business of a financial institution, earning income from making loans. Second, the Taxpayer earned over 80 percent of its income from making commercial loans.

The Taxpayer argued that loans could only be commercial loans if they were advertised and made available to any corporation in the business community at large. The Taxpayer argued that it was not truly making commercial loans because it did not make loans to independent third parties. Since the Taxpayer only made loans to affiliated corporations, over 80 percent of its income could not have come from making commercial loans. Therefore, it was not subject to the financial institutions tax.

There is no dispute that the Taxpayer earned its income from loans. The Taxpayer argues that the loans were not the sort of loan subject to the financial institutions tax – either commercial or personal. Since the loans were made to corporations, they were not personal loans. The Taxpayer argues that they were not commercial loans either because the loans were not made to independent third parties. The Taxpayer bases its argument on its contention that the general understanding of the word "commercial" implies business transacted between independent third parties. Further, the Taxpayer states that the term "commercial loan" is defined in *Black's Law Dictionary* (8th Edition 2004) as, "A loan that a financial institution gives to a business, generally for 30 to 90 days."

The Taxpayer's explanation of the meaning of "commercial loan" is unduly restrictive. The general understanding of the word "commercial" relates to transactions between businesses as opposed to with individual persons. It is defined as "the buying and selling of goods." *Webster's II New Riverside University Dictionary* (1988). The legal dictionary that the Taxpayer cites also refers only to "business." It does not specify independent third party businesses or non-affiliated businesses.

The Taxpayer also cites *Caterpillar Financial Services Corp. v. Indiana Department of State Revenue*, 849 N.E.2d 1235 (Ind. Tax 2005) in support of its contention that it did not qualify as a financial institution subject to the financial institutions tax. In *Caterpillar,* the court found that Caterpillar Financial Services was a financial institution because it made loans and extended credit through a variety of financing arrangements to the worldwide third party customers of Caterpillar Financial Services as well as related corporations. The Taxpayer distinguishes its situation because it only made loans to related parties rather than independent third parties as in the *Caterpillar* case. The Taxpayer makes a distinction without a difference. The *Caterpillar* case dealt with the issue of whether or not the financing arrangements were actually loans or extensions of credit. In this case, the Taxpayer and Department agree that the Taxpayer earned its income from loans. The issue is whether those loans were a variety that subjected the Taxpayer to the financial institutions tax. Therefore, the *Caterpillar* case does not

support the Taxpayer's contention that the Taxpayer was not subject to the financial institutions tax.

Finally, the Taxpayer argues that the Department's position on this matter would potentially broaden and change the definition of the term "financial institutions" for purposes of financial institutions tax without following the procedures prescribed at IC § 6-8.1-3-3(b). The Taxpayer errs in this conclusion. The Department is not broadening and changing its interpretation of the law. Rather, the Taxpayer is asking that the Department narrow the definition provided by IC § 6-5.5-1-17(d).

The Taxpayer offered significant documentation indicating that the Taxpayer, Corporation "A," and the affiliated corporations were separate entities that transacted business. The Taxpayer submitted a summary of the working capital notes, a summary of the real estate notes, and sample notes. These indicate that the Taxpayer earned at least 80 percent of its income from commercial loans. The Department correctly determined that the Taxpayer was subject to the financial institutions tax.

FINDING

The Taxpayer's protest is respectfully denied.

II. Financial Institutions Tax – Indiana Income.

DISCUSSION

After the Department determined that the Taxpayer was subject to Indiana financial institutions tax, the Department apportioned the Taxpayer's income to determine the amount of Indiana income subject to the tax. The Taxpayer protested the apportionment claiming that it was not transacting business within Indiana.

A business is "transacting business within Indiana" if it performs any of the activities stated at IC § 6-5.5-3-1 as follows:

(1) maintains an office in Indiana;
(2) has an employee, representative, or independent contractor conducting business in Indiana;
(3) regularly sells products or services of any kind or nature to customers in Indiana that receive the product or service in Indiana;
(4) regularly solicits business from potential customers in Indiana;
(5) regularly performs services outside Indiana that are consumed within Indiana;
(6) regularly engages in transactions with customers in Indiana that involve intangible property, including loans, but not property described in section

8(5) of this chapter, and result in receipts flowing to the taxpayer from within Indiana;
(7) owns or leases tangible personal or real property located in Indiana; or
(8) regularly solicits and receives deposits from customers in Indiana.

According to the audit summary, the Taxpayer shared office space with its parent corporation in Indiana and was a registered Indiana withholding agent. This office provided a sufficient connection to the state for Indiana to consider the Taxpayer's income Indiana income. The notice or proposed assessment based upon the audit report is presumed to valid. IC § 6-8.1-5-1(c). The Taxpayer's documentation was insufficient to rebut the presumption that the Taxpayer's office was located in Indiana. With an office and employees in Indiana, the Taxpayer had sufficient nexus to subject its income to Indiana taxation.

FINDING

The Taxpayer's protest is respectfully denied.

III. Tax Administration - Ten Percent Negligence Penalty.

DISCUSSION

The Taxpayer protests the imposition of the ten percent negligence penalty pursuant to IC § 6-8.1-10-2.1. Indiana Regulation 45 IAC 15-11-2(b) clarifies the standard for the imposition of the negligence penalty as follows:

> Negligence, on behalf of a taxpayer is defined as the failure to use such reasonable care, caution, or diligence as would be expected of an ordinary reasonable taxpayer. Negligence would result from a taxpayer's carelessness, thoughtlessness, disregard or inattention to duties placed upon the taxpayer by the Indiana Code or department regulations. Ignorance of the listed tax laws, rules and/or regulations is treated as negligence. Further, failure to read and follow instructions provided by the department is treated as negligence. Negligence shall be determined on a case by case basis according to the facts and circumstances of each taxpayer.

The standard for waiving the negligence penalty is given at 45 IAC 15-11-2(c) as follows:

> The department shall waive the negligence penalty imposed under IC 6-8.1-10-1 if the taxpayer affirmatively establishes that the failure to file a return, pay the full amount of tax due, timely remit tax held in trust, or pay a deficiency was due to reasonable cause and not due to negligence. In order to establish reasonable cause, the taxpayer must demonstrate that it exercised ordinary business care and prudence in

> carrying out or failing to carry out a duty giving rise to the penalty imposed under this section. Factors which may be considered in determining reasonable cause include, but are not limited to:
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> (1) the nature of the tax involved;
> (2) judicial precedents set by Indiana courts;
> (3) judicial precedents established in jurisdictions outside Indiana;
> (4) published department instructions, information bulletins, letters of findings, rulings, letters of advice, etc;
> (5) previous audits or letters of findings concerning the issue and taxpayer involved in the penalty assessment.
>
> Reasonable cause is a fact sensitive question and thus will be dealt with according to the particular facts and circumstances of each case.

The Taxpayer provided substantial documentation to indicate that its failure to pay the assessed tax was due to reasonable cause rather than negligence.

FINDING

The Taxpayer's protest to the imposition of the penalty is sustained.

KMA/LS/DK- January 31, 2008